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No. 127

IN THE

Supreme Court of the United States

October Term, 1935

UNITED STATES OF AMERICA,

Petitioner,

v.

CHARLES E. O'MALLEY, CLAUDE G. ALEXANDER and PETER
G. FARROW, as Executors of the Will of EDWARD H.
FARRIOR, deceased,

Respondents.

On Writ of Certiorari to the United States Court of Appeals
for the Seventh Circuit.

BRIEF FOR RESPONDENTS

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BRIEF FOR RESPONDENTS

QUESTION PRESENTED

Almost thirteen years before his death, the decedent created five irrevocable trusts. He did not retain an income or remainder interest in any of the trusts, although he was one of the three co-trustees of each trust. Each trust was funded by the decedent on its creation, but no

other property was ever transferred by the decedent to the trusts. The trustees were directed to pay out trust income to the trust beneficiaries, but had the right to retain the income and add it to trust principal. A portion of the income was retained.

The question presented is whether the Court below correctly held that the retained trust income was not "transferred" by the decedent within the meaning of Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, and was not includable in his gross estate for federal estate tax purposes.

STATUTES INVOLVED

Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, as amended, is not sufficiently set forth in the brief of the United States. It provides in pertinent part:

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property . . . [t]o the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise . . . under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death . . . the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom"

Omitted from the United States' brief is the phrase "(except in the case of a bona fide sale for an adequate and full consideration in money or money's worth)".

Other statutes cited in the Argument are set forth in an Appendix to this brief. They are: Internal Revenue Code of 1954, as amended, Section 641(a)(1) (26 U.S.C. 641(a)(1) (1964 ed.)); Internal Revenue Code of 1954, as amended, Section 2503(b) (26 U.S.C. 2503(b) (1964 ed.)); Internal Revenue Code of 1939, as amended, Sections 811(c) and (d) (26 U.S.C. 811(c), (d) (1952 ed.)); Internal Revenue Code of 1939, as amended, Section 1003(b)(3) (26 U.S.C. 1003(b)(3) (1952 ed.)).

STATEMENT

The statement of the United States is substantially correct. However, the only transfer of property by Fabrice to the trusts occurred when the trusts were created in December of 1936 and January of 1937—approximately thirteen years before Fabrice's death on October 13, 1949 (R. 2, 3, 4, 5). Fabrice retained no power to revoke, change, or modify the terms of the trusts for his benefit or in a manner by which he could ever acquire any interest in the corpus or income of the trusts (R. 57).

SUMMARY OF ARGUMENT.

The retained income of the trusts was never "transferred" by Fabrice within the meaning of Section 811(c) (1)(B)(ii) of the Internal Revenue Code of 1939. Neither the Congressional policy behind the Code's "transfer" sections, nor the statutory language itself, permits taxation of the mere accumulation of income on transferred property. That income was owned by the irrevocable trusts and the trustees merely directed that the trusts retain it.

It is fallacious to argue that the transfer of principal to the trusts was incomplete until the decedent's death and that the retained income therefore was "transferred" at

his death. The doctrine of an incomplete transfer was enunciated primarily in cases involving either revocable trusts or trusts where the decedent retained an income interest for his life. The doctrine of these cases should not be forced upon the present situation by strained analogies. The United States would displace all traditional concepts of ownership by awkward fictions. The principal here is taxable by reference to the statutory language; this statutory language does not support the proposition that the retained income was transferred by the decedent either before or at his death.

No loophole would be opened by affirming the decision below. The right which Fabrice retained is so narrow, and the over-all tax savings so dubious, that the facts of this case can hardly serve as a guide for a sophisticated tax avoidance plan.

The term "transfer" is definite in meaning and should not be given the tortured construction which the United States urges. Because taxpayers must be able to rely upon a clearly articulated and rational taxing system, Section 811(c)(1)(B)(ii) should be interpreted so as to give effect to the ordinary meaning of its terms. Any tax reform that would run contrary to the clear meaning of the statutory language should be left to Congress.

ARGUMENT.

A. Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, as amended (26 U.S.C. 811(c)(1)(B)(ii) (1952 ed.)), applies only to property "of which the decedent has at any time made a *transfer . . .*" (Emphasis added.) As the United States concedes in its brief (p. 7), the only real issue is whether Fabrice "made a transfer" of the retained income. A proper reading of Section 811(c)(1)(B)(ii) and an analysis of the statutory scheme in which the section appears conclusively demonstrate that the income earned by the irrevocable trusts was not "transferred" by Fabrice within the meaning of the section. That income therefore is not includable in Fabrice's gross estate. W

The basic policy behind the so-called "transfer" sections of the Internal Revenue Code of 1939 (26 U.S.C. 811(c), (d) (1952 ed.)), is to force into a decedent's gross estate for federal estate tax purposes, certain of the property which he once owned but subsequently transferred away. Property so taxed includes "transferred" property over which the decedent retained some measure of control, such as a life estate in it or the power to revoke a trust holding title to it.

Despite theoretical distinctions which are often drawn in estate tax problems, the federal estate tax law is essentially a pragmatic statutory system, designed to ignore legal fictions and to look to substance. See *Commissioner v. Estate of Church*, 335 U.S. 632, 644-45. The requirement of Section 811(c)(1)(B)(ii) that a "transfer" occur illustrates the pragmatic basis of the estate tax. This section requires inclusion in a decedent's gross estate of property] /

which he once owned and then "transferred", but over which he retained sufficient control to lead to the tax conclusion that it remained "his". Fabrice's estate thus has been taxed on the trust principle, because he once owned it and then transferred it subject to sufficient control to call for its inclusion in his gross estate.

But Fabrice never *owned* the retained income, and thus had nothing to "transfer" within the meaning of the statute. That income, under customary principles of property law, belonged to the trusts. Fabrice could not keep it himself, could not enjoy it, could not sell the right to it, could not cause it to be delivered to anyone but the trust beneficiaries. His sole right over it was, in conjunction with his co-trustees, to retain it in the trusts rather than to pay it out. As retained income, it would ultimately go to the trust beneficiaries. If there was a "transfer", it was not by Fabrice, because he had nothing to transfer. There was, moreover, no "transfer" of income at all. The trusts owned the income and retained it. The only income transferred was the trust income paid to the beneficiaries or expended for trust expenses, but there is no suggestion that it, too, is subject to federal estate tax.

A close analysis of the statutory language shows clearly that retained income was never meant to be taxed:

First, Section 811(c) contains an express exception for transfers involving a "sale for an adequate and full consideration in money or money's worth". This exception illustrates the Congressional purpose to tax only those interests which a decedent owned and could have sold. If the decedent did not own it, he could not have sold it. The exception is meaningless if the "property" referred to in the statute was never subject to sale by the decedent. If the

decedent did not own and could not have sold the property, he could not have "made a transfer" of it under the statute. The taxation of the principal fully satisfies the pragmatic requirements of Section 811(c)(1)(B)(ii).

Second, the statute commences by ". . . including the value at the time of his death of all *property* . . . [t]o the extent of any interest therein of which the decedent has at any time made a *transfer*" (Emphasis added.) When the statute refers to the type of control which will force this transferred property into the estate for tax purposes, the statute then, and only then, recognizes "income" as well as "property," for it refers to control as ". . . the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom" (Emphasis added.) Omission of the word "income" from the transfer provision evidences the Congressional intent to tax only transferred property and not retained income.

B. The United States argues, despite the clear statutory language, that the transfer of the original principal was "incomplete", and that therefore the transfer both as to principal and as to retained income took place only at the decedent's death (p. 8-9). That argument seeks to avoid what would otherwise have to be a tortured and illogical construction of the term "transfer" in Section 811(c)(1)(B)(ii). The argument is, however, completely misplaced here.

The "completeness" of a trust transfer was dealt with in *Commissioner v. Estate of Church*, 335 U.S. 632, 644-645 (cited by the United States at p. 5 of its brief):

"How is it possible to call this trust transfer 'complete' except by invoking a fiction? Church was sole owner of the stocks before the transfer. Probably their

greatest property value to Church was his continuing right to get their income. After legal title to the stocks was transferred, somebody still owned a property right in the stock income. That property right did not pass to the trust beneficiaries when the trust was executed; it remained in Church until he died. He made no 'complete' gift effective before that date, unless we view the trust transfer as a 'complete' gift to the trustees. But Church gave the trustees nothing, either partially or completely. He transferred no right to them to get and spend the stock income. And under the teaching of the *Hallock* case, quite in contrast to that of *May v. Heiner*, passage of the mere technical legal title to a trustee is not necessarily crucial in determining whether and when a gift becomes 'complete' for estate tax purposes. Looking to substance and not merely to form, as we must unless we depart from the teaching of *Hallock*, the inescapable fact is that Church retained for himself until death a most valuable property right in these stocks — the right to get and to spend their income. . . ."

That the transfer in *Church* was incomplete seems obvious. But how can the facts of *Church* be compared to those here? Fabrice did not retain the right to the income. He transferred to the trustees the irrevocable right to get and spend the income. The United States here asks the Court to ignore the substance of the Fabrice situation and to use the fiction of an "incomplete" transfer to trap the retained income. This is not necessary under the statute in order to tax the principal, and would be an unwarranted extension of *Church* for the purpose of taxing the retained income where the plain statutory language does not tax it.

Other cases cited by the United States (p. 5) are equally inapposite. In *Commissioner v. Estate of Holmes*, 326 U.S. 480, the decedent reserved the right during his lifetime to terminate the trusts and to distribute all of the trust property to the beneficiaries then entitled to receive it.

The issue there was whether that right to terminate fell within the statutory language of "alter, amend, or revoke". The Court held that it did. Fabrice had no such right.

Reinecke v. Northern Trust Co., 278 U.S. 339, dealt with two revocable trusts in which the decedent reserved a life income interest. The Court held those transfers not complete until the decedent's death, because they were revocable until the decedent died. The decision has no application here.

In short, the argument of an "incomplete" transfer is based primarily on cases which do not involve—as this case does—irrevocable trusts in which the decedent retained no income or remainder interest. The argument cannot be accepted and applied here except by doing violence to the facts.

The United States also argues that for purposes of estate tax law all traditional concepts of ownership must be abandoned in order to force retained income as well as principal into Fabrice's gross estate (p. 9). This, of course, simply begs the question. The reservation of the power to distribute or retain income may have forced the trust principal into Fabrice's gross estate for federal estate tax purposes, but there is no statutory or logical justification for claiming an ownership interest was thus created in the retained income which Fabrice could "transfer" within the meaning of the express statutory language.

The United States' analogy to the gift tax provisions of the Internal Revenue Code (p. 9) is also misplaced, because a vital point is ignored: the amount of gift tax depends directly upon the number of donees, the nature of the gifts to them, and when the gifts are made. Present interest gifts (such as distributions of income to a trust beneficiary) are entitled to an annual exclusion of the first \$3,000 to each donee; but future interest gifts (such

as income accumulations for ultimate distribution to a trust remainderman) are not entitled to that exclusion. Section 1003(b)(3) of the Internal Revenue Code of 1939, as amended (26 U.S.C. 1003(b)(3) (1952 ed.)) and Section 2503(b) of the Internal Revenue Code of 1954, as amended (26 U.S.C. 2503(b) (1964 ed.)). Thus, an essential criterion for accurate determination of the gift tax is the rule that the gift is deemed made only when the settlor directs either distribution or accumulation.

The estate tax law has no comparable provisions. No sound reason exists, therefore, for applying the gift tax rule in this situation, and the United States can cite no authority for its unique proposition.

C. The result below opens no loophole, as the United States suggests (pps. 10-12). The hypothetical taxpayer described by the United States, were he to rely on an affirmance of the decision below, would have only one inducement for patterning his actions on the facts of this case. That one inducement would be the right, with his co-trustees, to retain in an irrevocable trust a portion of the trust income. The estate tax savings on the retained income would be no inducement, for he could get that savings merely by foregoing the right to vote on retention of income. What price would he have to pay for that narrow right, under the hypothetical facts stated by the United States? His corporation would have to declare dividends payable to the trust and the trust would have to retain those dividends. Those retained dividends would, however, be taxable income to the trust, and income tax on them would have to be paid. Section 641(a)(1) of the Internal Revenue Code of 1954, as amended (26 U.S.C. 641(a)(1) (1964 ed.)). How then can the United States say (p. 11) that if trust income is accumulated " . . . the value of the trust will presumably be the same at his death as if

the earnings had been retained in the corporation"? In the first instance income tax is payable, and in the second instance it is not. The fact is that in the suggested hypothetical situation the income tax paid might well exceed the estate tax saved. Furthermore, the income tax is payable during the decedent's lifetime but the estate tax only after he dies.

The financial advantages of the so-called loophole are ephemeral at best, and would not afford a sound reason to retain the narrow power which Fabrice retained. Surely this Court should not anticipate that one interested in tax avoidance would deliberately keep so restricted a power if the price is (1) the certain taxability of principal and (2) the likelihood of paying more taxes on retained income than would be paid if the power were not kept.

D. No case cited by the United States, nor any case decided by this Court, compels the result the United States seeks. *Commissioner v. Estate of Church*, 335 U.S. 632, *Commissioner v. Estate of Holmes*, 326 U.S. 480, *Reinecke v. Northern Trust Co.*, 278 U.S. 339, and *Lober v. United States*, 346 U.S. 335, were all concerned with the nature of the control retained over property which was once owned by the decedent and "transferred" by him prior to death. In each case the transfer was clear, and involved specific property which the decedent at one time owned. This Court has never held, nor would the statutory language support a holding, that the mere power to retain income in an irrevocable trust creates an ownership in that income, which can be "transferred" by a decedent who never actually owned it. In closely analogous situations, the courts of appeals have held that the mere accumulation of income on transferred property is not subject to federal estate tax. *Commissioner v. Gidwitz' Estate*, 196 F. 2d 813 (7th Cir.); *Burns v. Commissioner*, 177 F.2d 739 (5th Cir.).

In *Commissioner v. McDermott's Estate*, 222 F.2d 665, 668 (7th Cir.), which is directly in point, the Court reasoned:

"Irrespective of all other considerations, property to be includible must have been transferred. Obviously, the accumulations here involved were not transferred by the decedent to the trustee. It is true, of course, that the accumulations represented the fruit derived from the property which was transferred but, even so, Congress did not make provision for including the fruit, it provided only for the property transferred. If it desired and intended to include the accumulations, it would have been a simple matter for it to have so stated."

The same reasoning has been followed by other courts. The Court of Appeals for the Sixth Circuit, in *Michigan Trust Co. v. Kavanagh*, 284 F.2d 502, followed *McDermott* with approval, stating at p. 506:

"There remains the question whether income represented by dividends on corporate stock is includible in the estate of the decedent. The Seventh Circuit Court of Appeals, on comparable facts and with careful discussion, rejected this concept. *Commissioner of Internal Revenue v. McDermott's Estate*, 7 Cir., 222 F.2d 665, 55 A.L.R. 2d 410. It applied its own rationalization in *Commissioner of Internal Revenue v. Gidwitz' Estate*, 7 Cir., 196 F.2d 813. In both cases, it was argued on behalf of the taxing authorities that transfers were not complete until decedent's death. The [lower court here] pointed out that the transfers from Hook to himself, as trustee, were fully completed when made in 1931. The securities transferred constituted the corpus of the estate and nothing remained to be done to complete the transfer. It is to be noted that the Tax Court, as recently as 1959, gives full effect to the *McDermott* decision. *McGehee, Estate of Delia Crawford*, 28 T.C. 412."

Although not directly in point because it involved the taxability in a donor's estate of stock dividends, paid out of current earnings on shares of stock given away by the donor in contemplation of death, *McGehee v. Commissioner*, 260 F.2d 818 (C.A. 5th) supports the rationale of *McDermott*. The Court said, 260 F.2d 818, 820:

"It is the interest of the decedent of which a transfer has been made which is to be included in the taxable estate of the donor. . . . The stock dividends were declared out of profits of the corporation earned subsequent to the gifts and hence were not a proportionate part of the corporation's assets at the time of the gift. This being so, it follows that the deceased donor never had any interest in the shares which were distributed as stock dividends or in the corporate earnings which the dividends capitalized. Although the tax is to be measured by the value of the transferred property as of the date of the donor's death, this does not mean that, for the purpose of determining what property was transferred, the gifts should be regarded as having been made as of the date of death. It has been held, and properly so, that income earned by previously taxed property should not be regarded as previously taxed property. *Gray v. Commissioner*, 19 B.T.A. 455. So also, we think, a stock dividend distributed as a capitalization of income of a corporation earned subsequent to a gift of the shares upon which the dividend was declared should not be regarded as a part of the gift."

E. The rule that the clear meaning of statutory terms should ordinarily govern is particularly persuasive in the field of taxation. Taxpayers and their attorneys should be able to govern their conduct by a taxing system which is both rational and based upon easily ascertainable criteria. Thus, the rule has developed that taxing statutes should be construed strictly in favor of the taxpayer; interpretations consonant with the ordinary meaning of the terms utilized are preferred. *Maass v. Higgins*, 312 U.S. 443; *Crooks v. Harrelson*, 282 U.S. 55. ✓

Another maxim particularly appropriate to tax cases is that courts will not, by judicial fiat, give an effect to a statute which Congress has not clearly intended. The uniformity demanded by a statutory tax scheme does not permit piecemeal alteration by the process of *stare decisis*. Such a piecemeal approach only creates more problems than it resolves. The tax laws are so rigidly compartmentalized that it is difficult to forecast the scope of a court decision beyond the facts at issue. Such unforeseen problems, frequently appearing in the tax field, underscore the advisability of leaving tax reform to Congress. See *Commissioner v. Brown*, 380 U.S. 563, 579; *American Automobile Ass'n. v. United States*, 367 U.S. 687, 697.

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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December, 1965